United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

76-7382

United States Court of Appeals

For the Second Circuit

CHARLES R. WOLFSON, RICHARD R. WOLFSON and LOUIS OKIN, as Executors of the Estate of NATHANIEL C. WOLFSON, deceased, and HERBERT A. FUENTE,

Plaintiffs-Appellants,

against

STEIN ROE & FARNHAM, STEIN ROE & FARNHAM STOCK FUND, INC., STEIN ROE & FARNHAM BALANCED FUND, INC., and HENRY THIELBAR,

Defendants-Appellees and Cross-Appellants,

R. DOUGLASS COOPER, CHARLES FARNHAM, HARRY HAGEY, JR., LAWRENCE HICKEY, LEMUEL HUNTER, JOHN JEUCK, SYDNEY STEIN, JR., RICHARD TEMPLETON, JOHN TITTLE, ROBERT WOODS, SR&F SERVICE CORPORATION, WACKER-ADAMS DATA SERVICE CORP.,

Defendants.

On Appeal from the United States District Court for the Southern District of New York

PLAINTIFFS-APPELLANTS' BRIEF

UNITED STATES COURT OF APPEALS
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PLAINTIFFS-APPELLANTS' BRIEF

PRELIMINARY STATEMENT

Plaintiffs appeal from a judgment of the District Court, Southern District of New York (HON. LAWRENCE W. PIERCE), dismissing the complaint, without costs, after trial. Defendants-appellees cross-appeal for costs.

Plaintiffs are shareholders of, respectively, STEIN ROE & FARNHAM STOCK FUND ("Stock Fund") and STEIN ROE & FARNHAM BALANCED FUND ("Balanced Fund"),

two open-end mutual funds jointly managed and advised by a broker-dealer partnership, S EIN ROE & FARNHAM ("Advisor").

Derivatively and in behalf of the two Funds, plaintiffs sue the Advisor and the individual defendants (1) for maintaining the artificial separateness of the two Funds so as to exact excessive management-advisory fees, (2) for failing to consider aggregation of the assets of the two Funds for fee-computation purposes so as to reduce the over-all fees, and (3) for failing to disclose to both Funds' shareholders the means whereby the excess was being charged, all in violation of the Investment Company Act of 1940 (15 U.S.C. §80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. §80b-1 et seq.) and established principles of fiduciary responsibility.

At the conclusion of trial, there being a question as to whether the individual defendants other than Thielbar were served, plaintiffs consented to dismissal of the complaint, without prejudice, as to such defendants. Plaintiffs also consented to dismissal, with prejudice, of Count Seven.

STATEMENT OF THE NATURE OF THE CASE

The central issue here is of first impression. Because of the unique fact situation presented, it is likely there will never be a second impression.

Each Fund has a separate investment advisory contract with the Adviser, which provides that the Adviser's fee shall be 1/2 of 1% of the first $100 million of assets, with a "step-down" to 2/5 of 1% on all assets in excess of $100 million. However -- and herein lies the uniqueness of this case -- unlike all other sister funds managed by a common adviser the two Funds here are not only managed in all aspects as one fund, but also have practically twin portfolios. The District Judge found that, apart from the 25% of Balanced Fund which is invested in fixed-income securities, the portfolios of both Funds were "so similar as to be for all practical purposes identical". The Court also found that this "mirror-image character" extended to all phases of the two Funds' operations.

Indeed, it can be said without fear of contradiction that the only area wherein the Adviser functionally treated the two Funds as separate entities was in the computation of its own annual management-advisory fee.

This, of course, is the plaintiffs' grievance. For, given the identity of equities and the simultaneity of all functions, it would appear that the defendants have maintained the separateness of the two Funds for the sole purpose of applying the higher 1/2 of 1% rate to the first $200 million, rather than $100 million, in assets, thereby achieving for the Adviser an annual

unjust enrichment of $100,000.

The Court below, while it indeed found that the Adviser managed the two Funds as one, nevertheless did not feel compelled to the conclusion which we believe is obvious, to wit, that the Adviser should also be paid on the basis of managing one aggregate fund with a stepdown at $100 million.

As to the plaintiffs' second claim that the directors never considered aggregation and that the Adviser never advised them of its feasibility and inherent saving, the Court's response was the same as that of defendants: that the Adviser fully discharged its responsibility by separately informing each Fund's directors of its expenses, fees and comparative industry figures vis à vis that particular Fund; that the directors of each Fund in turn fully discharged their responsibility by considering the Adviser's fees, expenses and expense studies solely in relation to the respective Fund, and on this basis determined that the dollar amount payable by the respective Fund under its separate advisory agreement was fair and reasonable.

This compartmentalized approach, of course, begs the central conceptual issue of the case, which is whether maintaining an artificial separateness of assets within one large and functionally identical fund, for no other purpose than that of computing advisory fees, is a proper discharge of the Adviser's and directors'

fiduciary responsibility.

In the same vein, the Court below concluded that informing the shareholders of each separate Fund of the details relative to such Fund's separate advisory contract was sufficient disclosure to validate the successive shareholder approvals. In point of fact, until this lawsuit, only a simultaneous holder of shares in both Funds was on notice of their mirror-image character, and thus on notice of the true stepdown point. But a shareholder of only one Fund was not only uninformed of the true facts but also, as we shall show, actively misled.

THE FACTS

Unless otherwise indicated, this recital follows the findings of fact contained in the District Judge's memorandum opinion. (184A-200A)*

Balanced Fund and Stock Fund are open-end, no-load mutual funds. Balanced Fund normally has approximately 25% of its assets invested in long-term debt securities, with the remainder invested in common stocks and other equity securities. Stock Fund consists almost entirely of equity securities. (187A)

The Adviser is the manager, investment adviser, and distributor of shares for both Funds. As such, it makes investment recommendations to each Fund's board of directors, and furnishes office space and clerical and bookkeeping services to the Funds. The two Funds share common office space. (188A)

As found by the District Judge, "There is significant overlap between those who are partners of the Adviser and those who sit on the boards of the two Funds." With the exception of four individual defendants, all are members of the Adviser partnership. (188A-189A)

Each Fund has a separate but identical investment advisory contract with the Adviser. The fee basis for each Fund is, annualized, 1/2 of 1% of the first $100 million of such separate Fund's net asset value, with a "stepdown" to 2/5 of 1% of the net

*References are to joint appendix (A) or plaintiffs' exhibits (PX).

asset value in excess of $100 million. (189A)

The crucial factual findings of the Court are the following:

> "12. Despite the different investment objectives of the Funds, the undisputed evidence shows that the issues held by Stock Fund and the equity securities portion of Balanced Fund are so similar as to be for all practical purposes identical. Further, each Fund usually effects trading in the same issues at the same time, acting upon the same advice given by the Adviser. Each Fund usually acquires and divests itself of similar issues at the same time. The buy and sell orders of each Fund are placed simultaneously as often as possible. As of December 31, 1971, some forty-eight issues were held by both Funds, constituting 86% of Stock Fund and 71% of Balanced Fund. Of these forty-eight issues, twenty issues were at that time held in identical amounts by each Fund.
>
> "13. This essentially identical nature of Stock Fund and of the equity portion of Balanced Fund has been in existence since before the commencement of this action and continued until the date of trial. The facts demonstrating the mirror-image character of the major portion of the two Funds are undisputed and are set forth in §§3(a)(xiv) through (a)(xxi) of the Pre-trial Order."
> (190A-191A)

Although not mentioned by the Court, the uncontradicted evidence is that the boards of the two Funds always met simultaneously (PX162, p. 10); that the common directors (i.e. most of them) received two fees for each such meeting (PX162, p. 71); that at each such meeting they simultaneously heard and considered reports common to both Funds (PX162, p. 13); but that when the advisory

contracts came up for renewal, they were considered separately. (PX162, p. 31)

The Court found "that eleven of the eighteen largest mutual fund complexes in the nation calculate management fees separately for each fund in the complex." (191A). (This, of course, is unresponsive to plaintiff's contention, which is not a generalized claim that all funds having a common adviser are required to be aggregated for fee computation purposes, but that only these two mirror-image Funds should be so aggregated).

The Court also found "that at least four of the fund complexes which do aggregate assets for fee calculation purposes charge an amount which is substantially higher than the <u>sum</u> of the fees charged to Stock Fund and Balanced Fund". (191A) , emphasis the Court's). (The Court omitted to mention that the fees charged by these four other advisers would have been <u>still</u> higher had they <u>not</u> aggregated assets for fee calculation purposes).

The Court further found "that the plaintiffs have failed to establish by a fair preponderance of the evidence their claim that a reduction in the total amount of the fees charged would result from a merger or aggregation of the Funds." (192A)

This, of course, was palpable error, because plain arithmetic decrees otherwise, a point on which defendants' witnesses Cooper and Hunter readily agreed (124A-140A). But the Court was not defying the plain arithmetic of aggregation. This finding was, rather, predicated on testimony of defendants' witnesses threatening to negate the resultant fee reduction (presumably even a court-ordered reduction) by negotiating a new advisory contract between themselves that would provide for a higher stepdown point. (104A, 120A-121A, 140A-141A)

The evidence conclusively established that, at least until this lawsuit, the subject of aggregating the assets of the two Funds for the purpose of fee computation was never discussed or given any consideration by either of the two boards of directors, nor was this obvious method (employed by at least four other mutual fund complexes) ever communicated to the boards by the Adviser. (PX162, p. 35; 110A)

The Court made a finding which we believe was unresponsive to this evidence. The Court found "that the directors of <u>each</u> Fund have at all times pertinent been fully informed of the expenses of <u>each</u> Fund as well as of the profit to the Adviser derived from managing <u>each</u> Fund." (192A , emphasis supplied). The Adviser also furnished the directors

of each separate Fund with studies comparing said Fund's fees and performance with those of other mutual Funds. (192A). The Court concluded that, on the basis of these compartmentalized considerations, the directors of each board "determined independently and consistently that all expenses and fees paid to the Adviser are fair and reasonable in amount." (192A)

The Court's further finding that the stockholders of each separate Fund voted their overwhelming approval of such Fund's advisory contracts (193A-194A) is factually correct, but nonetheless unresponsive. For the evidence is clear that, until this lawsuit, neither the Adviser nor the respective directors informed the stockholders of each Fund that, by reason of the "mirror-image character" of the other Fund, the stepdown was actually at $200 million rather than at $100 million, and that the Adviser was therefore being paid twice, at the higher rate, for precisely the same services. Until this lawsuit, this information was omitted from every report, proxy statement and prospectus.

There is only one document in evidence which even purports to communicate information about the fund complex as a whole. That is the information brochure sent to prospective shareholders.(169A-183A)

And it turns out that the only three sentences of this 15-page brochure which touch on the Adviser's fees are actively misleading:

> "For its services as investment adviser and manager of the Funds, Stein Roe & Farnham receives a management fee. For the Balanced and Stock Funds, the fee, expressed on an annual basis, is 1/2 of 1% of the first $100 million of average net assets. The fee is reduced to 2/5 of 1% of average net assets exceeding $100 million." (182A p. 14, emphasis supplied).

STATEMENT OF THE ISSUES PRESENTED

1. Was the Adviser charged with a fiduciary duty to aggregate the assets of both Funds so as to reduce its management-advisory fees?

2. Were the directors of each Fund, together with the Adviser, charged with a fiduciary duty to consider aggregation of the two Funds' assets for the purpose of reducing the Adviser's fees?

3. Was the approval by the shareholders of each Fund to the several advisory contracts obtained through material misrepresentations and omissions respecting the point of the stepdown?

STATUTES INVOLVED

During the course of the litigation amendments to both the Investment Company Act of 1940 and the Investment Advisers Act of 1940 became effective. It therefore became necessary to clarify, by pre-trial order, both the period covered by each count of the amended and supplemental complaint and the statutory basis claimed for each such count. Herewith, in tabular form, is the clarification contained in the stipulated pre-trial order (except for Count 7, which was dismissed on consent):

Count	Time Covered	Statutory basis
1st	Until June 14, 1972	Investment Company Act §§36(a) and 37 and former section 36
2nd	After June 14, 1972	Investment Company Act §36(b)
3rd	Until June 14, 1972	Investment Company Act §36(b)
4th	Until December 31, 1975	Investment Advisors Act §206
5th	Until December 31, 1975	Investment Company Act §15(a)
6th	Until trial	Investment Advisors Act §§206 and 207

Former Section 36 of the Investment Company Act, in effect until December 13, 1970, provided, in pertinent part:

> "The Commission is authorized to bring an action in the proper district court of the United States or United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts --
>
> "(1) as officer, director, member of any advisory board, investment adviser, or depositor;"

Section 36(a) of the Investment Company Act [15 U.S.C. §80a-35(a)] effective December 14, 1970, reads, in pertinent part:

> "The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts --
>
> "(1) as officer, director, member of any advisory board, investment adviser, or depositor;"

Section 36(b) of the Investment Company Act [15 U.S.C. §80a-35(b)] effective June 14, 1972, provides in pertinent part:

> "For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a

fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

"(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

"(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

"(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient."

Section 37 of the Investment Company Act [15 U.S.C. §80a-36] provides:

> "Whoever steals, unlawfully abstracts, unlawfully and willfully converts to his own use or to the use of another, or embezzles any of the moneys, funds, securities, credits, property, or assets of any registered investment company shall be deemed guilty of a crime, and upon conviction thereof shall be subject to the penalties provided in section 49. A judgment of conviction or acquittal on the merits under the laws of any State shall be a bar to any prosecution under this section for the same act or acts."

Former Section 15(a) of the Investment Company Act [15 U.S.C. §80a-15(a)], in effect until December 13, 1971, provided in pertinent part:

> "After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and --
>
> "(1) Precisely describes all compensation to be paid thereunder;"

Present Section 15(a) of the Investment Company Act [15 U.S.C. §80a-15(a)], effective December 14, 1971, provides in pertinent part:

> "It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract,

which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company and --

"(1) precisely describes all compensation to be paid thereunder:"

Section 15(c) of the Investment Company Act [15 U.S.C. §80a-15(c)], effective December 14, 1971, provides, in pertinent part:

"It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

Section 206 of the Investment Advisers Act [15 U.S.C. §80b-6] provides, in pertinent part:

"It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly --

"(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

"(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceipt upon any client or prospective client;

***

"(4) to engage in any act, practice or course of business which is fraudulent, deceptive, or manipulative."

Section 207 of the Investment Adviser's Act [15 U.S.C. §80b-7] provides:

> "It shall be unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission under section 203 or 204, or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

POINT I

In View Of The Unique Unity Of The Two Subject Funds, The Adviser Was Charged With The Fiduciary Duty To Aggregate Their Assets For Fee Computation Purposes.

Admittedly, there is no precise precedent for the claims herein presented. But there is abundant precedent for the fiduciary principle involved, not only at common law but also as expressed in the Investment Company Act and the Investment Advisers Act, both before and after the 1970 amendments. If, in the name of reducing management-advisory fees, advisers and directors have been charged with the retroactive duty to employ such indirect and esoteric devices as crediting of give-ups (Report of S.E.C. "Public Policy Implications of Investment Company Growth", H. R. Rep. No. 2337, 89th Cong., 2d Sess., 1966, p. 173), recapture of brokerage commissions (Moses v. Burgin, 445 F. 2d 369, 1 Cir., 1971; Fogel v. Chestnutt, 533 F. 2d 731, 2 Cir. 1975), and recapture of underwriting commissions and tender-offer fees (Papilsky v. Berndt, S. D. N. Y., CCH Fed. Sec. L. Rep. 1976, ¶95,627), then surely advisers must be even more forcefully charged with the duty of acting directly to eliminate a double payment of these fees.

At the outset, it is important to state what this case is not about. Plaintiffs do not propose that every adviser of every fund complex is required, either by statute or equity, to aggregate assets of the complex,

even though to do so would reduce the advisory fees; if the funds are truly different, requiring different treatment, the adviser is certainly entitled to be paid for its differentiated services. Nor is there any quarrel, as there was in Saxe v. Brady, 184 A. 2d 602, 610 (Ch. Del . 1963) and in Acampora v. Birkland, 220 F. Supp. 527 (D. Colo. 1963), relied upon by the Court below, with either the rate or the dollar amount of the fee; in each case, the attack on the rate or amount, as such, was correctly rejected by the Court.

What we have here is a unique situation, not likely to be repeated, where the Adviser manages two virtually identical Funds as one fund, yet maintains their separateness for the sole purpose of exacting an additional 1/10 of 1% per year on the first $200 million of their aggregate assets.

When the defendants agreed on a stepdown at $100 million, it was a judgment that the Adviser could handle the additional net asset value at a lower rate, without any diminution of services, and still make the profit desired. This was testified to by defendants' witness Woods (104A-105A). Both the stepdown point and rate were business judgments made by the defendants, not imposed by any Court or any other outside authority. What plaintiffs object to is that these defendants, having fixed a presumably reasonable stepdown point and rate,

thereafter exercised their control over the aggregate assets so as to perpetuate the artificial separate existence of two like funds, for the sole purpose of producing more dollars for the same services -- all without ostensibly disturbing what outwardly appears to be a reasonable formula. Plaintiffs' charge of excessiveness is not predicated, much as defendants would like it to be, upon any departure from "industry standards" or upon the mystique of any particular dollar amount.

Let us assume the reverse situation, where the Adviser was managing one large fund comprised of the assets of both Funds herein. In that situation, the shareholders would be paying the Adviser 1/2 of 1% on the first $100 million and 2/5 of 1% on the second $100 million, just as the contracts now provide. Now assume that the defendants then split the equity portion of this large fund into two co-equal halves, solely in order to obtain a double application of the higher rate. It cannot be denied that such a ploy would immediately be denounced as "shocking" and "unconscionable", and unquestionably enjoined. Yet, precisely the same unjust enrichment has in fact been achieved by the defendants here by artificially maintaining the legal separateness of the two Funds organized by them.

The Court below disposed of Count One (covering the period up to June 14, 1972, the effective date of new §36(b) of the Investment Company Act) in the following terms:

4. In order to succeed on their claim in Count One that the management fees were so excessive as to violate 15 U.S.C. §80a-36, plaintiffs must demonstrate a wilful conversion by defendants and that the amount of the fees are so "shocking" that no director with sound business judgment would approve them; see Acampora v. Birkland, 220 F. Supp. 527, 548 (D. Colo. 1963); Saxe v. Brady, 184 A. 2d 602, 610 (Ch. Del. 1962) (Seitz, Chancellor)."

This standard is much too primitive, not at all in accord with Moses v. Burgin, supra, and Fogel v. Chestnutt, supra, and not even in accord with the cases upon wh ch the Court below relied. In Moses, the Court did not find it necessary to remind the adviser and directors of the self-evident duty to refrain from "wilful conversion"; the Court's concern was with defendants' more sensitive fiduciary obligation to reduce the advisory fee whenever practicable (445 F. 2d 374, 378-379). The Moses Court found that duty not or compelled by general equitable principles, but more specifically by former Section 36 of the Investment Company Act:

> "We believe, however, that the Act imposes a more fundamental and persuasive requirement where, because of the structure of investment trusts, self-dealing is not the exception but, so far as management is concerned, the order of the day."

In Moses, the method enjoined upon defendants for reducing the advisory fee was (after give-ups were terminated) recapture of commissions. Here, no such circumlocution is necessary; the method is at hand.

Nor did this Court, in Fogel v. Chestnutt, supra, require the showing of a "wilful conversion" or a "shocking" dollar amount of fees in order to impose liability upon a fund adviser. It was enough that there was a legally justifiable means at hand for reduction of fees. This Court clearly recognized that the duty to recapture was but another means of discharging the underlying duty to reduce advisory fees. It noted:

> "Plaintiffs' real complaint is...that the Adviser, for selfish motives, refrained from handling portfolio transactions in a manner that would have diverted a portion of the commissions to itself, with an attendant decrease in the advisory fee -- in substance a charge of breach of fiduciary duty resulting in corporate waste" (533 F. 2d 745).

Here, too, it is only the selfish motives of the Adviser that have stayed it from calculating its fees on an aggregate basis.

While noting that its view of former section 36 was "less expansive" than that of the Moses Court, this Court held with respect to an adviser's fiduciary duty both before and after the 1970 amendments:

> "[W]e have held that the Act implicitly established a federal standard of fiduciary duty in respect of dealings between a mutual fund and its adviser. Brown v. Bullock, 294 F. 2d 415, 421 (2 Cir. 1961); Rosenfeld v. Black, 445 F. 2d 1337, 1345 (2 Cir. 1971), a duty which the 1970 amendment makes explicit 'with respect to the receipt of compensation for services'". (533 F. 2d, at 745).

Even prior to the effective date (December 14, 1970) of present §36(a) of the Investment Company Act and the effective date (June 14, 1972) of present §36(b) of the Act, Count One was supported by former §36, §37, the clear intention of the Act, and the teaching of this Court in Brown v. Bullock, 294 F. 2d 415 (2d Cir. 1961). There is no need to find, as alleged in Brown, that the directors are "tools of the Management Company" (294 F. 2d, at 420). The fact is the directors of the Funds here and the partners of the Adviser are all intertwined "and in truth were acting in [the Adviser's] interest rather than in that of the Fund." (294 F. 2d, at 420). And it would appear from Moses v. Burgin, supra, 445 F. 2d at 373, that even before the effective date of §36(b) there existed a private right of action under former §36 for "gross abuse of trust" and certainly under §36(a), effective December 14, 1970, "for breach of fiduciary duty." This disposes of the District Judge's third conclusion of law, which denied plaintiffs' standing to invoke these sections.

An even stronger case was made out by plaintiffs under Count Two, predicated on §36(b) of the Investment Company Act, which explicitly renders an investment adviser liable in a derivative suit for "breach of a fiduciary duty with respect to the receipt of compensation for services." Yet, despite the factual situation

unfolded, the Court below held, in its eleventh conclusion of law:

> "11. Plaintiffs have also failed to establish, as charged in Count Two, that the Funds and the Adviser are liable for contracting for excessive fees in violation of 15 U.S.C. §80a-35(b). In this regard, the statute specifically allows the Court to consider the approval of the fees by the directors and shareholders; see Id. §80a-36(b)."

Although §36(b) expressly created a private right of action for breach of "a fiduciary duty with respect to the receipt of compensation for services", it pointedly omitted to define the "applicable standards." (Cf: Fogel v. Chestnutt, 533 F. 2d, at 745). Obviously, Congress could not undertake to do so, without enacting Scott on Trusts, Bogert on Trusts and the Restatement of Trusts as part of the statute. So we are relegated in this search to the principles that have guided fiduciaries in other areas.

An analogous situation is presented by the "sliding scale" of attorneys' fees in personal injury actions prescribed by the First and Second Departments of the Appellate Division in New York (McKinney's Consol. Court Rules, §603.4(e)(1), §691.4(e)(1). Under that formula, an attorney is entitled to 50% of the first $1,000. recovered, 40% of the next $2,000., 35% of the next $22,000., and 25% of the remainder. Assuming a recovery to a wife, for her injuries, in the

sum of $10,000., and to her husband, for his expenses and "loss of services", in the sum of $1,000., would their attorney be acting as a fiduciary if he regarded the two recoveries as separate solely in order to obtain 50% of the husband's recovery? To pose the question is to answer it.

We suggest that there is clear guidance in the field of trusts. In Matter of Johnson, 170 N. Y. 139 (1902), New York's Court of Appeals held that five trusts arising in the same estate could not be aggregated for fee purposes, and thus the three trustees had to divide one fee in each trust instead of receiving the three fees to which they would be entitled if the five trusts were treated as one trust of more than $100,000. The rationale of the decision is that statutes (and presumably contracts) should be reasonably interpreted so as to minimize the fees involved. To the same effect is Matter of Wilson (Surr. West. 1938) 167 Misc. 758, 763.

In McAlpine v. Potter, 126 N. Y. 287 (1891), Matter of Slocum, 169 N.Y. 153, (1901) and Matter of Ziegler, 218 N. Y. 544 (1916), the court pointed out that even where a fiduciary acts in two separate capacities, i.e. as executor and trustee, if he functionally operates on one corpus and the work is for all purposes the same, he is not entitled to double commissions. The analogy is plain: When an investment

advisor functionally operates on two Funds treated for investment purposes as one, and the work is the same for both, the investment advisory fees should be computed directly on the aggregate of the two funds.

In dismissing Count Two the District Judge obviously accorded great weight to the directors' and shareholders' approvals of the successive fee arrangements, and cited subsection (2) of §36(b) as his predicate. This issue will receive further treatment in Point III _infra_. Here, suffice it to say that this subsection, which permits director and shareholder approvals to "be given such consideration by the court as is deemed appropriate under all the circumstances", could not have been intended by Congress as a justification for erasing any fiduciary duty intended by the section or as a means of converting a breach thereof into acceptable conduct. The subsection must have been enacted in the light of established principles of corporation trust, one of which is that there can be no approval of "breach of fiduciary duty resulting in corporate waste" (Cf. _Fogel_ v. _Chestnutt_, _supra_, 533 F. 2d at 745) on less than a unanimous vote of the shareholders and that there can be no approval at all without full disclosure of all the facts needed to cast an informed vote. _Robbins_ v. _Banner Industries, Inc._, 285 F. Supp. 758 (S.D.N.Y. 1966).

The central conceptual error of defendants, and into which the Court below fell, is that the Adviser's manner of computing its fees is irrelevant, and that the only relevant consideration is the total dollar amount received by the Adviser. This viewpoint was given concrete expression by defendants' witness Woods, at the end of his direct examination. Asked whether there would "necessarily" be any reduction of the advisory fee under aggregation, Mr. Woods responded:

> "I feel sure there would not be, because we would suggest that the contracts be changed and we would have a higher break point on the fees.
>
> "We look at the total dollars we are getting for managing these two Funds and what we think we are making from them, and that's the important step to me in starting forward, not how you allocate." (103A-104A)

We suggest that this testimony bespeaks what Mr. Justice Cardozo characterized as an "arrested sense of trust." Unfortunately, however, defendants' rationale was accepted by the Court below. (Conclusion of Law, No. 17). (198A-199A)

But if this reasoning stands uncorrected, defendants can justify, not two but ten mirror-image funds, all separately maintained solely to obtain a ten-fold imposition of the higher rate. If this reasoning be adopted, the personal injury lawyer in the example just cited could justify separate imposition of the

"sliding scale", and executor-trustees could split or aggregate, depending on which course maximized the fee, the corpus under their trusteeship. Finally, if this reasoning were adopted, the foundation for the duty to recapture would be lost, since the only criterion urged by defendants is the total dollar amount of fees needed or desired by them.

Plaintiffs have raised no issue over the rate or dollar amount of the fee, because rates and amounts are subjects of bargaining, "a matter of judgment on the part of the persons who pay for them" (Acampora v. Birkland, supra, 220 F. Supp., at 549, Saxe v. Brady, supra, 184 A. 2d 602, Ch. Del. 1962), but plaintiffs are vitally concerned with the manner of computation, because computation is either right or wrong. That is also why defendants' elaborate studies and comparisons with the rest of the industry in respect of expenses, fees and performance are here irrelevant. For no matter what the Adviser's fee is, if it abided by its own contemplated stepdown that fee would necessarily be reduced by $100,000. per year. The fiduciary obligation cast on defendants would be the same whether the Adviser's fee, measured in terms of dollars or expense-fee ratios, turns out to be the highest or the lowest in the industry.

Defendants' position is really an attempt to quantify a fiduciary's obligation, to fix a dollar point below which a fiduciary fulfills his trust and beyond which he lapses into self-dealing. We respectfully suggest that this is an impossible feat, and its impossibility was in fact recognized in Saxe v. Brady, supra, and Acampora v. Birkland, supra.

Perhaps the most clear-cut demonstration of the sheer arbitrariness of the separation is provided by the following exchange between the Court and defendants' witness Hunter:

> "THE COURT: Maybe I should inquire further into this.
>
> "Mr. Hunter, what would you consider to be a policy or business justification for having separate contracts between Stein, Roe & Farnham and each of the Funds for the purpose of obtaining their services with respect to those holdings of each of the Funds which consist of common stock?
>
> "THE WITNESS: Well, each Fund is a separate unit.
>
> "THE COURT: Given that.
>
> "THE WITNESS: And therefore it seems to me right that there be a separate contract between each unit and each Fund and the investment advisor.
>
> "THE COURT: Why?
>
> "THE WITNESS: Well, simply because they are different units. They have different stockholders. They have different officers and board of directors." (144A-145A)

Defendants' only possible justification for their position would be a showing that the two Funds require, and have been accorded, differentiation of investment advice, services and other treatment. This they have not shown, notwithstanding the mass of documents introduced by them and notwithstanding that all the witnesses heard at the trial were theirs.

On the contrary, as developed in pre-trial discovery and as found by the court below, there has been no differentiation whatsoever of either investment advice or services. Consequently, there is no basis for the Adviser's charging the Funds the additional 1/10 of 1% per year, and the Adviser and directors should be held liable in damages for this excess amount.

POINT II

The Adviser Failed in Its Duty To Inform The Directors Of Both Funds That Its Fees Could Be Reduced Through Aggregation. The Directors Failed In Their Duty To Consider This Means Of Fee Reduction.

Lawrence Hickey, a partner of the Adviser, and a director and officer of both Funds, testified as follows:

> "Q Prior to the instant lawsuit, was the issue of aggregation of fees of the investment adviser respecting Balanced Fund and Stock Fund ever raised at a directors meeting?
>
> "A. I do not recall it being raised." (PX162, p. 35)

He further testified that, at all of these meetings, counsel for both Funds were present, as well as one or more partners of the Adviser. (PX162, pp. 41-42)

Robert Woods, a partner of the Adviser, and a director and President of both Funds, testified as follows:

> "Q Before this action was commenced in '72 was there any discussion in the board of directors meeting of either Fund as to the possibility of reducing the management fee by insisting on aggregating the assets before the step down took place?
>
> "A I don't recall any such discussion.
>
> "In each Fund it was the firm and the directors who went to the shareholders and suggested the reduction in fee when we got close to $100 million, and we thought these fees and total costs were very fair and we never discussed aggregating." (110A)

Section 15(c) of the Investment Company Act [15 U.S.C. §80-a15(c)] specifically provides:

> "It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company."

Moses v. Burgin, supra, established the existence of liability on the part of directors of a fund for failure to consider available methods of reducing the investment advisory fee, and on the part of the investment adviser for failure to call such possibilities to the attention of the directors. The Court held, at 445 F. 2d 384:

> "We therefore conclude that the Management defendants were guilty of gross misconduct within the meaning of the Act in failing to disclose the possibility of NASD recapture to the unaffiliated directors. The two individual management defendants, and the Management corporations, must be held liable for damages under section 36."

And this Court in Fogel v. Chestnutt, supra, at 533 F. 2d 745 agreed with the First Circuit that

"under the scheme of the Investment Company Act an investment adviser is 'under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund' -- a situation which occurs much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business operations."

This Court went on to hold, at pp. 749-750:

"The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons."

Clearly, had the Adviser and directors here been motivated to achieve a saving in fees, they would have discerned that a disarmingly simple means was directly at hand. But the defendants' "eager eye" was focussed on quite different considerations.

In an attempt to distinguish the instant case from Fogel, the Court below lapsed into grievous error. In its 17th conclusion of law the Court held:

"17. In Fogel, the outside directors were unaware of the possibility of brokerage commission recapture, and thus they needed information from the insiders; see Id. at ¶98,995. In this case, the option of aggregating assets for fee computation purposes, engaged in by a number of other mutual fund complexes, was known to the outside directors and thus there was no need for disclosure of the option." (emphasis supplied).

This is just not so. The trial transcript is clear that defendants' lead counsel sought to rehabilitate his clients' dereliction by questioning them as to investigations made by them after the suit was commenced. The testimony of Mr. Woods shows that his entire research into the fund complexes which do aggregate assets for fee-computation purposes was stimulated by this suit and only by this suit. Not only is Mr. Woods' entire testimony on this subject in the present tense (80A-84-A) but also, it will be recalled, he admitted that there was never any discussion of aggregation until this suit (110A).

This Court, in Fogel, succinctly evaluated this type of after-the-fact reconstruction, observing at 533 F. 2d 750:

> "Apart from the salutary prophylactic effects of such a rule, courts can have little confidence in post litem motam expressions by independent directors as to what they would have done if management had put all the facts before them. Under the best of circumstances there is bound to be doubt about the independence of the 'unaffiliated' or now the 'disinterested' director; see Note, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich. L. Rev. 696, 701 (1972). These should not be enhanced by recognizing a post hoc reconstruction of mental processes as a defense."

The remainder of the District Judge's 17th conclusion of law is as follows:

> "Further, since the Court has found that aggregation would not necessarily have reduced the total fee, the directors were not required to engage in 'doubtful experiments virtually unsupported by custom or convention or court decision.'"

But this was precisely the quotation in the Moses District Court opinion (316 F. Supp. 31, 57) which moved the First Circuit to comment, at 445 F. 2d 383:

> "We are not so sure the Court's answer was correct."

In the instant case, the answer comes through loud and clear: far from any novelty, the plain fact is that other fund complexes have for years aggregated for fee computation purposes. (106A) It may be that the directors, qua directors, were not expected to be aware of this practice, but such lack of knowledge is certainly no defense to the Adviser, which is supposed to be knowledgeable as well as having legal counsel for just such purpose.

In this connection, it is a matter of public record that the aggregation in the United Fund complex, of which Mr. Woods became aware in this suit, resulted from a settlement in a derivative suit charging excessive fees (Ruskay v. Reed, Sup. Ct., N.Y. Co., Index No. 8283/1964).

Because the Adviser failed to call attention to aggregation, and because the directors failed to consider it, they are liable in damages to the Funds for the annual $100,000. that was and is being lost.

POINT III

Breaches of Trust, Especially Those In Violation of Statutorily-Expressed Public Policy, Are Incapable Of Ratification. In Any Event, The Shareholder Approvals Of The Successive Advisory Contracts Prior To This Suit Were Induced By Material Omissions And Misrepresentations.

The Court below invoked the shareholder approvals of the successive advisory contract to support three of its conclusions of law:

5. That shareholder ratification shifted the burden of proof to the objecting shareholder "to convince the Court that no person of sound business judgment would be expected to entertain the view that the consideration was a fair exchange for the value which was given."

10. That the "overwhelming shareholder approvals" were an important factor in evaluating whether the fees were "so excessive as to constitute a violation of [former §36]."

11. That present §36(b) permits the court to "consider the approval of the fees by the...shareholders" in determining whether that section (breach of fiduciary duty in relation to fees) was violated.

We respectfully suggest that, in each of these conclusions, the Court below overlooked well-established qualifications of the defense of ratification. As was said in Winkelman v. General Motors Corporation, 44 F.

Supp. 960 (S.D.N.Y. 1942) at page 985:

> "The duty of full and frank disclosure of all pertinent facts affecting a transaction of this magnitude, where directors and officers have a personal interest opposed to that of the corporation, is predicated upon moral considerations. Where directors seek the approval of the stockholders for a transaction in which the directors stand to profit at the expense of the corporation, every item of possible profit to the directors and all information that would enable the stockholders to form a correct estimate of the benefit accruing to the directors must be disclosed, if the approval of the stockholders is to be any protection to the directors."

And in Robbins v. Banner Industries, Inc., 285 F. Supp. 758 (S.D.N.Y. 1966), the Court in dismissing the complaint, stated the applicable law at page 763:

> "The acts complained of are the issuance of stock to the directors and their breach of fiduciary obligation. Whether we regard the law of New York or Missouri as controlling, actions such as those alleged could not be ratified by anything less than a unanimous vote of the shareholders, and could not be ratified at all without the full disclosure which plaintiff herself claims is lacking."

On both counts stated in Robbins, for all the reasons heretofore shown, defendants' approvals of the successive advisory contracts could not amount to legal ratification thereof. Whether defendants' breach of fiduciary obligation consisted simply of its conduct in maintaining the artificial separation of the Funds, or consisted of the Adviser's failure to communicate the desirability of aggregation and the defendants' failure to consider it, or consisted of a combination

of these acts and omissions, the result is the same: the acts and omissions were not susceptible of ratification.

A reading of §15(a) of the Investment Company Act (both before and after the 1970 amendments) makes it plain that majority approval, standing alone, is insufficient to validate an advisory contract. There are two conditions precedent to such validation: majority approval and precise description of the adviser's compensation. The placement of the word "and" in the statute insures that the failure of the contract to make the requisite precise description cannot be cured by even an overwhelming vote of the shareholders.

This Court, commenting on this statute in Brown v. Bullock, supra, 295 F. 2d at 421, said:

> "We think §15(a) and (b) laid down a requirement of annual approval not merely formal but substantial..."

Under Count Five, predicated upon §15(a), plaintiffs established that none of the successive advisory contracts disclosed to the shareholders of one Fund that the proposed fee was loaded with the double payment described in Point I, supra. Defendants, of course, will retort that §15(a) calls for no more than "precise description" of the separate advisory contract, viewed separately, and that they have therefore fully complied with §15(a). But if we correctly read this

Court's thinking in Brown v. Bullock, supra, and the shareholders' annual approval is to be "not merely formal but substantial", then the shareholders of each Fund should have been informed, at the very least, of the assets, operation and fee arrangements of the other Fund as well.

As Dean Shulman said in "Civil Liability and the Securities Act", 43 Yale Law Journal 227, at 242, what is required is

> "a picture not simply of the show window, but of the entire store * * * not simply truth in the statements volunteered, but disclosure."

Full disclosure, in the sense of alerting the shareholders to the entire picture, was absent not only from the successive advisory contracts submitted for approval to the shareholders, but was also absent from every report, proxy statement and prospectus issued by each Fund. Thus, not only were the successive approvals invalid but, additionally, the Adviser herein has been in violation of §§206 and 207 of the Investment Advisers Act.

But the dereliction of the Adviser herein lay not simply in material omission but also in material misrepresentation. In a history that has been otherwise devoid of any information to the shareholders calculated to disclose the entire picture and the true stepdown, the Adviser nevertheless issued an

information booklet (DX-DJ) to "prospective shareholders". This one document which was contemplated to reach the attention of both Fund's shareholders is fifteen pages long. Only three sentences touch on management advisory fees:

> "For its services as investment adviser and manager of the Funds, Stein Roe & Farnham receives a management fee. For the Balanced and Stock Funds, the fee, expressed on an annual basis, is 1/2 of 1% of the first $100 million of average net assets. The fee is reduced to 2/5 of 1% of average net assets exceeding $100 million." (182A , emphasis supplied).

Thus, not only have the defendants breached their duty of trust by refusing to aggregate the two Funds' assets for fee computation purposes, but have compounded their breach by making it appear to their own shareholders and the investing public that they do, in fact, aggregate for fee computation purposes.

CONCLUSION

The judgment below dismissing the complaint should be reversed (except as to Count Seven) and damages awarded in favor of the Funds and against the Adviser. Since the damages are readily computed, no remand is necessary. The costs and disbursements of the action, together with reasonable attorneys fees, should be awarded to plaintiffs.

Respectfully submitted,

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By: ______________________
A Member of the Firm

Of Counsel,
ROBERT MARKEWICH

Service of 2 copies of the within Brief is hereby admitted this 7th day of Jan. 1977

Signed Sullivan & Cromwell

Attorney for Defendants-Appellees and Cross-Appellants Stein Roe & Farnham and Henry Thielbar